

Message Text

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PAGE 01 ROME 05881 01 OF 02 100043Z

64

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LIMITED OFFICIAL USE SECTION 1 OF 2 ROME 5881

PASS TREASURY AND FRB

E.O. 11652: N/A

TAGS: EFIN, IT

SUBJECT: VIEWS OF MILANESE BANKERS ON ITALIAN ECONOMIC
SITUATION

1. SUMMARY. DURING VISIT TO MILAN APRIL 5-7, ASST TREAS-
ATT AND DEPARTMENT OF TREASURY OFFICIAL VISITED WITH MILAN-
ESE BANKERS TO DISCUSS ITALIAN ECONOMIC SITUATION, ESPECIALLY
FOREIGN EXCHANGE MARKET DEVELOPMENTS. CONCLUSIONS WERE: (1)
ECONOMIC RECOVERY IS JUST BEGINNING, IS WEAK, AND WILL BE
SLOW IN DEVELOPING MOMENTUM, (2) COMMERCIAL CREDIT DEMAND
IS FAINT, ESPECIALLY FOR INVENTORY BUILDING, (3) MEDIUM AND
LONG-TERM INVESTMENT PROSPECTS ARE BLEAK, (4) INFLATIONARY
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PAGE 02 ROME 05881 01 OF 02 100043Z

EXPECTATIONS ARE HIGH AS GOI SEEMS TO BE LOSING FIGHT AGAINST

REDUCING INFLATION, (5) RECENT GOI MONETARY POLICY IS VIEWED AS ERRATIC AND PRESENT HIGH LEVELS OF INTEREST RATES SHOULD SLOWLY FALL, (6) EXPORT PROSPECTS ARE GOOD FOR 1976 BUT SUPPLY PROBLEMS WILL OFTEN SURFACE PREVENTING PROMPT DELIVERY AND CONSTANCY IN QUALITY, (7) LIRA EXCHANGE RATE PATH IN 1976 FORECAST TO BE MARKED BY WIDE OSCILLATIONS OF THE RATE, ESPECIALLY IN THE SECOND QUARTER, WITH SOME RATE IMPROVEMENT IN LAST HALF OF YEAR, (8) LATEST BATCH OF GOI FOREIGN EXCHANGE MEASURES WERE SEEN TO CONTAIN TIMING AND SUBSTANCE ERRORS BUT WERE JUDGED TO BE STEPS IN RIGHT DIRECTION, AND (9) BANKERS HAD OVERALL HIGH CONFIDENCE IN GOI ECONOMIC POLICY VOICING LITTLE CRITICISM. END SUMMARY.

2. ECONOMIC RECOVERY. BANKERS FELT THAT ECONOMIC RECOVERY WAS IN EARLIEST STAGES AND NOT YET WIDELY DIFFUSED THROUGHOUT ECONOMY. INDICATORS ARE FAINT, AND THE EXPECTATION IS FOR LONG, GRADUAL RECOVERY. STRENGTH OF GERMAN RECOVERY CITED AS CRITICAL TO ITALIAN PROSPECTS.

3. COMMERCIAL CREDIT DEMAND. COMMERCIAL CREDIT DEMAND SO FAR IN 1976 IS MUCH LIGHTER THAN EXPECTED GIVEN PHASE OF ECONOMIC CYCLE AND WIDESPREAD INFLATIONARY EXPECTATIONS. BANKING COMMUNITY HAD EXPECTED LAST FALL A PICK-UP IN DEMAND FOR COMMERCIAL FINANCING, ESPECIALLY FOR BUILDING INVENTORIES, BUT THIS HAS LARGELY NOT DEVELOPED AND BANKS ARE CURRENTLY QUITE LIQUID DESPITE RECENT GOI CREDIT RESTRICTIONS. EMBASSY COMMENT: ONE MIGHT EXPECT THAT ITALIAN FIRMS HAVE ADOPTED MORE SOPHISTICATED INVENTORY CONTROL TECHNIQUES AFTER BEING CAUGHT OUT OF PHASE WITH RAW MATERIAL PRICES IN PAST YEARS AND THAT SLOW ECONOMIC RECOVERY MAY PLACE DAMPER ON INVENTORY BUILDUP.

4. INFLATIONARY EXPECTATIONS. CONTINUATION AND ACCELERATION IN INFLATIONARY PRESSURES ARE WIDELY ANTICIPATED IN BANKING AND BUSINESS CIRCLES. JANUARY AND FEBRUARY SPURTS IN PRICE INDICES ARE WORRISOME AND INDICATIVE OF YEARLY PRICE PATH. ALTHOUGH BANKERS WINCED AT SUGGESTED 30 PERCENT DECEMBER 76/ DECEMBER 75 CPI FIGURES ADVANCED BY VISITORS, FIGURE DID NOT SEEM ENTIRELY UNLIKELY. PREVALENCE OF DISMAL INFLATIONARY FEELINGS COUPLED WITH LACK OF ATTRACTIVE INVESTMENT OPPORTUNITIES IN ITALY (RECENT POOR PERFORMANCE OF STOCK MARKET WAS COMMONLY MENTIONED AS EXAMPLE OF THIS) HAVE ENCOURAGED CAPITAL FLIGHT AND CONSUMPTION. THERE WAS MUCH CARPING ABOUT WASTEFUL ITALIAN PRIVATE CONSUMPTION PATTERNS AND CALLS FOR SOME TYPE OF "AUSTERITY MEASURES" TO KEEP THE "PEOPLE FROM CONSUMING TOO MUCH.

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PAGE 03 ROME 05881 01 OF 02 100043Z

TUNITIES IN ITALY (RECENT POOR PERFORMANCE OF STOCK MARKET WAS COMMONLY MENTIONED AS EXAMPLE OF THIS) HAVE ENCOURAGED CAPITAL FLIGHT AND CONSUMPTION. THERE WAS MUCH CARPING ABOUT WASTEFUL ITALIAN PRIVATE CONSUMPTION PATTERNS AND CALLS FOR SOME TYPE OF "AUSTERITY MEASURES" TO KEEP THE "PEOPLE FROM CONSUMING TOO MUCH.

5. GOI MONETARY POLICY. RECENT TIGHTENING OF GOI MONETARY

POLICY WAS FELT TO BE NECESSARY, ESPECIALLY AFTER RAPID CREDIT EXPANSION IN FOURTH QUARTER 1975. SOME BANKERS FELT (NOT UNEXPECTEDLY GIVEN THEIR BIASES) THAT DEGREE OF TIGHTENING WAS EXTREME AND LARGELY DUE TO POOR LIQUIDITY CONTROL IN FOURTH QUARTER. NO ONE FELT THAT "CREDIT CRUNCH" WAS APPROPRIATE TERM FOR CURRENT SITUATION, SINCE HIGHER INTEREST RATES HAVE HAD ONLY A MARGINAL EFFECT ON BORROWING. POTENTIAL BORROWERS ARE BELIEVED TO BE RATHER INTEREST RATE INSENSITIVE DUE TO LACK OF INVESTMENT PLANS GIVEN EXPECTED SLUGGISH ECONOMIC RECOVERY AND POLITICAL UNCERTAINTIES. DEMAND FOR INVENTORY FINANCING WAS CHARACTERIZED AS VERY LOW AND PERPLEXING GIVEN WIDESPREAD INFLATIONARY EXPECTATIONS. NO FURTHER TIGHTENING OF CREDIT AND HIKES IN INTEREST RATES WERE FORESEEN. IT WAS ALSO THOUGHT THAT CURRENT GOI MONETARY POLICY SHOULD NOT BE CLASSED AS "STOP-GO" ACCORDING TO BANKERS, SINCE BOI HAS CONTINUED TO SELL SOME TREASURY BILLS TO THE BANKS AT NON-MARKET PRICES BETWEEN REGULAR AUCTIONS, SMOOTHING CONSIDERABLY THE EFFECT OF THE LUMPY INJECTIONS OF CREDIT INTO THE MONETARY SYSTEM. IN SUM, THE CURRENT GOI MONETARY POLICY WAS SEEN BY THE BANKERS TO HAVE A MARGINALLY NEGATIVE IMPACT ON THE RECOVERY, VERY LITTLE IMPACT ON ALTERING INFLATIONARY EXPECTATIONS AND ON INFLATION ITSELF, AND SLIGHT POSITIVE IMPACT ON CURBING NEW CAPITAL FLIGHT (TOGETHER WITH SPECIAL FOREX MEASURES).

6. EXPORT PROSPECTS. THERE WAS GENERAL CONSENSUS THAT ITALIAN EXPORTS ARE QUITE COMPETITIVE IN WORLD MARKETS, ESPECIALLY IN THE NEWLY TAPPED OPEC MARKET. DEMAND FOR EXPORTS WAS FORECAST TO STRENGTHEN THROUGHOUT 1976. SUPPLY PROBLEMS WILL OCCASIONALLY SURFACE, PREVENTING PROMPT DELIVERY AND CONSTANCY IN QUALITY, BUT MORE TRADITIONAL SUPPLY CONSTRAINT OF PUSING AGAINST CAPACITY WAS SEEN TO BE QUITE FAR OFF BEFORE BECOMING BINDING. BANKERS DID NOT IN GENERAL AGREE WITH LIMITED OFFICIAL USE

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PAGE 04 ROME 05881 01 OF 02 100043Z

BELIEF THAT ITALY MIGHT LOSE OUT IN WORLD MARKETS DUE TO LOW TECHNOLOGICAL NATURE OF EXPORTS, BUT HAD NOT THOUGHT ABOUT ISSUE IN DEPTH. EFFECT OF RECENT DEVALUATION ON EXPORT COMPETITIVENESS WILL BE FELT IN NEXT SIX MONTHS. ONE BANKER SAID THAT THREE QUARTERS OF INCREASED COSTS RESULTING FROM DEVALUATION WILL BE IMMEDIATELY PASSED ON IN HIGHER PRICES WHILE ROUGHLY ONE QUARTER WILL BE RETAINED TO INCREASE COMPETITIVE EDGE. HOWEVER, GIVEN COMMON FEELING THAT LABOR COSTS WILL CONTINUE TO ADVANCE, THIS ADVANTAGE SHOULD BE NEARLY COMPLETELY ERODED BY END OF YEAR.

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PAGE 01 ROME 05881 02 OF 02 091732Z

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LIMITED OFFICIAL USE SECTION 2 OF 2 ROME 5881

PASS TREASURY AND FRB

7. 1976 FOREIGN EXCHANGE MARKET DEVELOPMENTS. BULK OF CON-
VERSATIONS CENTERED ON RECENT FOREX DEVELOPMENTS AND PROS-
PECTS THROUGH YEAR END. AVERAGE EXPECTATION IS FOR STRONG
PRESSURE ON LIRA DURING SECOND QUARTER ACCOMPANIED BY WIDE
OSCILLATIONS IN RATE (FROM 820 TO 900 WERE ONE BANKER'S PARA-
METERS) FOLLOWED BY IMPROVEMENT IN LAST HALF, TRADITIONAL
STRONG PERIOD FOR LIRA DUE TO LARGE SERVICE ITEM RECEIPTS,
ENDING AT 820-830 AT YEAR END. COMMON BELIEF WAS THAT LIRA
IS CURRENTLY UNDERVALUED (I.E., AT 850-870 RANGE) BASED ON
ECONOMIC ANALYSIS OF APPROPRIATENESS OF RATE. VIEWPOINTS
COALESCED ON NEED FOR "POLITICAL PREMIUM" TO RATE BUT NO NUM-
BERS WERE ATTACHED TO CONCEPT. EVERYONE WAS SURE THAT CON-
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PAGE 02 ROME 05881 02 OF 02 091732Z

TINUED DISAGREEMENT WITHIN GOI ON RATE MANAGEMENT POLICY AND DEVELOPMENT PATH COUPLED WITH LACK OF RESERVES (I.E., LACK OF REAL POLICY OPTIONS), WHILE FRENCH AND GERMANS DEMANDED GREATER RATE STABILITY, WOULD CREATE DIFFICULT ENVIRONMENT FOR BOI EFFORTS. POLITICAL DIMENSION MUST ALSO BE ADDED TO PICTURE, FURTHER RESTRICTING BOI MANEUVERING ROOM. ONE BANKER REMARKED THAT ITALY IS FORTUNATE THAT THE LIRA IS RELATIVELY INSULATED FROM THE WORLD FOREX MARKETS AND THAT THIS MAKES JOB OF BOI MUCH EASIER. GIVEN THE POOR RESULTS WE NOW SEE, HE WONDERED WHERE WE WOULD BE IF OUR CURRENCY WERE MORE INTEGRATED IN WORLD MARKET, I.E., MORE SUBJECT TO EXTERNAL PRESSURE.

8. CONFIDENCE IN GOI FOREX POLICIES. OTHER THAN ELICITING SOME TECHNICAL QUIBBLINGS, VISITORS WERE UNABLE TO PROMPT CRITICISMS OF GOI FOREX POLICIES IN 1974 THROUGH 1975 PERIOD AND ESPECIALLY IN EARLY 1976 WHEN MARKET WAS SEVERELY DISRUPTED. OTHER THAN SOME FAULT-FINDING ON TIMING, NO HARD BALLS WERE TOSSED AT THE GOI ON THIS SCORE. IN FACT, CONSIDERABLE PRAISE OF GOOD JOB DONE BY BOI UNDER SUCH ADVERSE CIRCUMSTANCES WAS FREQUENTLY HEARD. ONE BANKER EXPLAINED THAT BOI HAD IN FACT FOSTERED THE INSULATION OF THE LIRA FROM INTERNATIONAL FOREX MARKETS AND FROM SPECULATION IN 1974-1975 PRECISELY BECAUSE OF ITS EFFECTIVE INTERVENTION POLICY. HE ADDED THAT FOREIGN CLIENTS CONSTANTLY COMPLAINED TO HIM THAT SPECULATION AGAINST THE LIRA WAS "DANGEROUS" AND NOT UNDERTAKEN DUE TO HEAVY AND EFFECTIVE BOI INTERVENTION. HE CITED 1973 BOI ACTIONS WHICH BURNED A NUMBER OF FOREIGN SPECULATORS AS ANOTHER EXAMPLE OF GOOD RATE MANAGEMENT POLICY. VOLPE

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